R4105 - 17.7

THE CONFERENCE BOARD

Worldbusiness Perspectives No. 57
October 1980

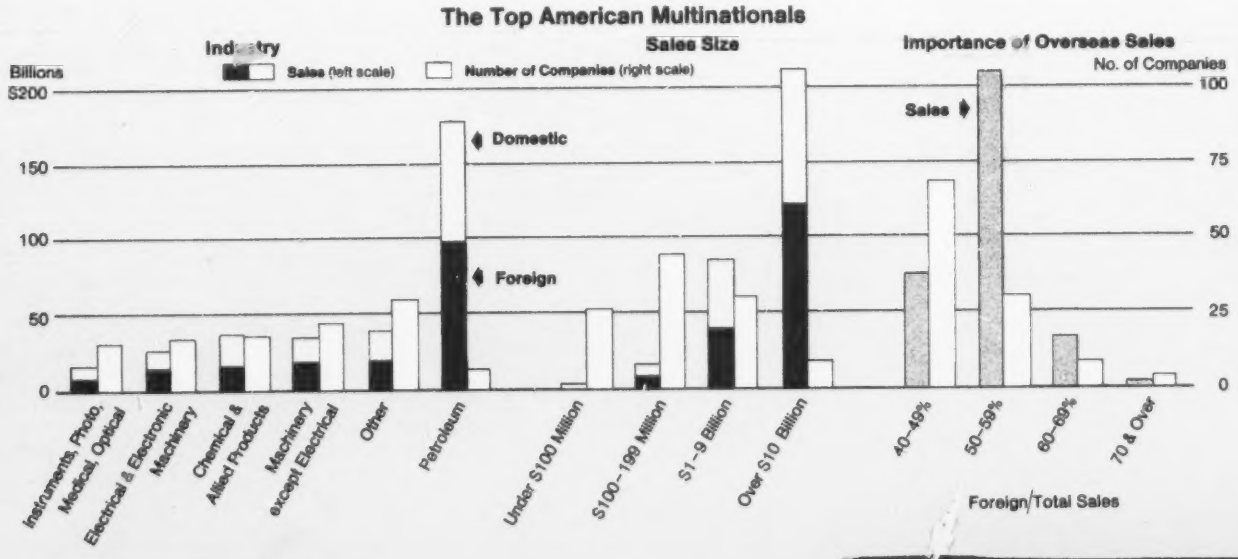
Another Look at Multinationals

Underlying the vast and growing literature on U.S. multinational corporations is a confusing array of definitions of these corporations. Magnitude of sales, revenues, assets or employment are used in some studies; multicountry operations and multinational employment in others. An increasingly popular test is the percentage of total company sales that are made abroad (including exports and sales of foreign manufacturing units). But this latter test is usually applied only to the country's largest, best known companies.

Presented in this analysis are 107 U.S. manufacturing firms with 40 percent or more of their 1978 sales derived from foreign sources. Data are from The Conference Board's Key Company Directory and drawn largely from public records. Some companies that would qualify for the list are undoubtedly missing. Some firms listed have been acquired by other companies since 1978. While the list contains a large number of firms accepted as multinational by any conceivable standard—Exxon, Mobil, IBM for example—it also includes a surprisingly large number of medium and smaller companies that are rarely included in listings of multinational firms.

Industry Distribution

Seventy-two of the 107 companies are concentrated in just four of the twenty major manufacturing groups—nonelectrical machinery, electrical and electronic equipment, chemicals (primarily pharmaceuticals), and instruments. Another six are major oil firms, which collectively accounted for more overseas sales than the other four groups combined. Seven of the firms listed



© 1980THE CONFERENCE BOARD, INC.

BEST AVAILABLE COPY

United States Leaders in Foreign Sales—1978

Rank	Company	Foreign Sales as Percent of Total Sales	Total Sales ($ millions)	Foreign Sales ($ millions)	Principal Industry Group
1.	Granger Associates	94	23	22	Electrical-electronics
2.	Hoover Co.	70	692	482	Electrical-electronics
3.	International Flavor & Frangrances	67	366	245	Chemicals
4.	Texaco Inc.	66	28,608	18,927	Petroleum refining
5.	Dibrell Bros.	64	277	177	Tobacco
6.	CPC International	63	3,222	2,030	Food
7.	Nicolet Instrument Corp.	62	34	21	Instruments
8.	Mohawk Data Sciences Corp.	61	178	109	Machinery, except electrical
9.	A. Schulman, Inc.	61	189	115	Chemicals
10.	Mobil Corp.	59	34,736	20,481	Petroleum refining
11.	Standard Oil Company of California	59	24,106	14,275	Petroleum refining
12.	American Brands, Inc.	58	5,177	3,008	Tobacco products
13.	Ferro Corp.	58	494	286	Chemicals
14.	The Gillette Co.	58	1,710	991	Fabricated metal
15.	Graham Manufacturing Co. Inc.	58	39	22	Fabricated metal
16.	Measurex Corp.	58	89	52	Electrical-electronics
17.	Black & Decker Manufacturing Co.	57	960	545	Machinery, except electrical
18.	Colgate Palmolive	57	4,312	2,441	Household and personal care products
19.	Gulf Oil Corp.	57	18,069	10,245	Petroleum refining
20.	Nashua Corp.	57	509	290	Paper and allied products
21.	Dentsply International Inc.	56	212	118	Instruments
22.	NCR Corp.	56	2,611	1,450	Machinery, except electrical
23.	Pfizer Inc.	56	2,362	1,320	Chemicals
24.	Cameron Iron Works	55	462	256	Machinery, except electrical
25.	Huyck Corp.	55	123	68	Textile mill products
26.	Stanley Home Products	54	193	104	Miscellaneous
27.	Gelman Sciences	53	27	14	Machinery, except electrical
28.	Parker Pen Co.	53	409	217	Miscellaneous
29.	Revell, Inc.	53	47	25	Miscellaneous
30.	IBM Corp.	52	21,076	11,040	Machinery, except electrical
31.	ITT Corp.	52	19,399	10,023	Electrical-electronics
32.	Raychem Corp.	52	238	124	Primary metal
33.	H. H. Robertson Co.	52	387	201	Fabricated metal
34.	Fife Corp.	51	17	9	Instruments
35.	Ionics Inc.	51	32	16	Electrical-electronics
36.	J. Ray McDermott & Co.	51	1,294	660	Fabricated metal
37.	Engelhard Minerals	50	10,154	5,103	Chemicals
38.	Exxon Corp.	50	63,896	31,948	Petroleum refining
39.	Richardson-Merrill Inc.	50	945	473	Chemicals
40.	Foxboro Co.	49	396	194	Instruments; photographic, medical and optical
41.	General Refractories	49	414	202	Stone, clay and glass
42.	Siliconix Inc.	49	43	21	Electrical-electronics
43.	Fischer & Porter Co.	48	148	71	Instruments; photographic, medical and optical
44.	Hewlett-Packard	48	1,737	826	Instruments; photographic, medical and optical
45.	NCH Corp.	48	223	107	Chemicals
46.	Reece Corp.	48	40	19	Electrical-electronics
47.	Reynolds Metals Co.	48	2,829	1,357	Primary metal
48.	Spectra-Physics Inc.	48	66	32	Instruments; photographic, medical and optical
49.	Scott Paper Co.	48	1,725	827	Paper and allied products
50.	Weatherford International, Inc.	48	98	47	Machinery, except electrical
51.	AMP Inc.	47	801	376	Electrical-electronics
52.	Dow Chemical Co.	47	6,888	3,237	Chemicals
53.	Mesta Machine Co.	47	117	55	Machinery, except electrical
54.	Steelmet, Inc.	47	150	70	Secondary or scrap metals
55.	Sterling Drug Inc.	47	1,315	622	Pharmaceuticals and household products

Rank	Company	Foreign Sales as Percent of Total Sales	Total Sales ($ millions)	Foreign Sales ($ millions)	Principal Industry Group
56.	Xerox Inc.	47	5,902	2,787	Instruments; photographic, medical and optical
57.	American Standard, Inc.	46	2,111	971	Fabricated metal
58.	The Coca-Cola Co.	46	4,338	1,983	Food
59.	Albany International	45	289	130	Engineering fabrics & other industrial products
60.	Millipore Corp.	45	184	83	Machinery, except electrical
61.	Inforex, Inc.	45	63	29	Machinery, except electrical
62.	R. P. Scherer Corp.	45	147	66	Chemicals
63.	Camco, Inc.	44	56	24	Machinery, except electrical
64.	Cascade Corp.	44	63	28	Machinery, except electrical
65.	Dow Corning Corp.	44	479	209	Chemicals
66.	Emhart Corp.	44	1,346	597	Machinery, except electrical
67.	Foster Wheeler Corp.	44	1,488	655	Fabricated metal
68.	Grolier Inc.	44	243	106	Printing-publishing
69.	Harman International Industries Inc.	44	137	62	Electrical-electronics
70.	International Banknote Co.	44	85	37	Printing-publishing
71.	Merck & Co.	44	1,662	731	Chemicals
72.	Schering-Plough Corp.	44	1,083	475	Chemicals
73.	The Sippican Corp.	44	30	13	Electrical-electronics
74.	Wang Laboratories Inc.	44	185	81	Machinery, except electrical
75.	Avon Products, Inc.	43	2,015	864	Chemicals
76.	Johnson & Johnson	43	3,497	1,506	Health care
77.	Pako Corp.	43	68	29	Processing equip., photography, graphic arts, x-ray
78.	Perkin-Elmer Corp.	43	581	249	Instruments; photographic, medical and optical
79.	Prime Computer, Inc.	43	93	40	Machinery, except electrical
80.	Product Research & Chemical	43	57	24	Chemicals
81.	Technicon Corp.	43	276	120	Instruments; photographic, medical and optical
82.	Warner Lambert Co.	43	2,879	1,239	Chemicals
83.	Analog Devices Inc.	42	66	27	Electrical-electronics
84.	Baxter Travenol Laboratories Inc.	42	1,004	421	Chemicals
85.	Burroughs Corporation	42	2,460	1,023	Machinery, except electrical
86.	Franklin Mint Corp.	42	266	116	Miscellaneous
87.	Hughes Tool Co.	42	659	276	Machinery, except electrical
88.	Molex Inc.	42	72	30	Electrical-electronics
89.	Norton Company	42	960	403	Stone and Clay
90.	Occidental Petroleum Corp.	42	6,316	2,623	Petroleum refining
91.	Plenum Publishing Co.	42	20	8	Printing-publishing
92.	Singer Company	42	2,469	1,040	Electrical-electronics
93.	Union Special Corp.	42	115	48	Electrical-electronics
94.	Xomox Corp.	42	101	42	Fabricated metal
95.	Kratos Inc.	41	23	9	Instruments; photographic medical and optical
96.	Peerless Manufacturing Inc.	41	14	6	Machinery, except electrical
97.	Polaroid Corp.	41	1,377	559	Instruments; photographic, medical and optical
98.	Smith International Inc.	41	452	186	Machinery, except electrical
99.	Ampex Corp.	40	316	126	Electrical-electronics
100.	Applied Power Inc.	40	160	64	Machinery, except electrical
101.	Boeing Co.	40	5,463	2,185	Transportation equipment
102.	General Dynamics Corp.	40	3,205	129	Transportation equipment
103.	Medtronic Inc.	40	182	72	Electrical-electronics
104.	Mine Safety Appliances Co.	40	243	97	Instruments; photographic, medical and optical
105.	Polychrome Corp.	40	111	44	Machinery, except electrical
106.	Sunbeam Corp.	40	1,178	472	Electrical-electronics
107.	Verbatim Corp.	40	22	9	Machinery, except electrical

had over $10 billion each in foreign sales, and sixty of them did over $100 million each in foreign business.

Fourteen companies had less than $50 million in total annual sales and 26 had under $100 million. These are scarcely the dimensions of economic power that, in the public mind, challenge the sovereignties of foreign governments.

Other factors are at work in these smaller firms, including following their industrial customers abroad, artful acquisition of foreign firms that complement their own product lines, and highly specialized products with an inherently global market. One can add management's perspective of the company's future to this list.

Executives of Camco and Weatherford, both oil supply firms, and Graham Corp. a supplier to major engineering firms, cite requests by their U.S. customers for overseas supply. G.H. Tausch, President of Camco, explains that "a number of American-based oil companies asked us to provide sales and service wherever in the world they might be operating." Similarly, F.D. Berkeley, President of Graham, notes that "the chemical and petroleum industries that we serve have plants in many foreign countries in which American-built equipment is used."

This "drag" effect on small firms by the international activity of their large domestic customers is widely recognized but has never been measured. It often provides the smaller firm with a ready-made "export" market without substantial promotion costs.

Need for Foreign Investment

But overseas sales are not always achieved by small companies on an export basis alone. Some of the companies listed, despite their modest size, have had to invest heavily abroad to achieve foreign sales of these dimensions. The President of Cascade in Portland describes his firm's experience in making hydraulic equipment for internationally ambitious customers:

"Our original-equipment manufacturing customers all had overseas operations from a U.S. base. As a consequence, we were literally forced into investing in foreign manufacturing activities at a time when the company had neither the financial strength nor the management talent for such an ambitious undertaking. In 1958, we purchased a majority interest in a privately owned Dutch manufacturing company, that was operated as a joint venture until 1968 when we acquired 100 percent ownership. We paid one hell of an initiation fee in terms of the drain on our financial and management resources, but in retrospect it has proven to be one of the best decisions we have ever made."

When the product itself has a global market, the managements of smaller firms seem as ready to "go global" as the nation's giant companies. David Bossen, President of the California-based producer of computer control systems, Measurex Corp., affirms: "We recognized that approximately two-thirds of the world market for computer-based process control systems lay outside the United States. We wanted to participate in the world market. Therefore, we set up an aggressive plan to develop a worldwide sales and service network."

The manager for corporate planning at Gelman Sciences makes a similar point: "Our product line is primarily in the health-care industry and we feel that our markets outside the United States are just as important as those based domestically."

Conspicuously absent from the listing are firms in currently "import-impacted" industries—textiles, transport equipment, steel, appliances. While many firms in these industries have substantial foreign sales, their major focus has been on the huge domestic market for their products.

As a whole, the list suggests that participation in the world marketplace by U.S. firms is more heterogeneous and broader based than is generally recognized. Size has little to do with success abroad; product, customer profile, and management attitude are key elements.

James Greene

J. Frank Gaston, Editor
A bimonthly report from

THE CONFERENCE BOARD, INC.
845 Third Avenue, New York, N.Y. 10022
(212) 759-0900 Telex 234465 and 237282

THE CONFERENCE BOARD IN CANADA
25 McArthur Road
Ottawa, Ontario, K1L-6R3, Canada
(613) 746-1261

THE CONFERENCE BOARD IN EUROPE
Avenue Louise, 326 - Bte 48
B-1050 Brussels, Belgium
(02) 640 62 40 Telex 63635

R4105-17.8 A

THE CONFERENCE BOARD

Worldbusiness Perspectives No. 58
December 1980

FOREIGN CAPITAL EXPENDITURES BY AMERICAN COMPANIES
Some Signs of Strength in 1981

The most striking development revealed in the latest (October) Conference Board survey of capital expenditures abroad is the reduced percentage of American manufacturing companies that plan to hold 1981 expenditures to the 1980 level. The October survey (pertaining to 1981) showed nearly 37% planning to hold to about the 1980 level. This is down from the more than 39% of companies so replying to the April survey when asked about their 1980 plans in comparison with 1979.

Most of the shift was to the category, "planning to spend more," in 1981, 47% in the most recent survey compared with 45% in the April, 1980, survey. This shift suggests greater expenditures overseas than have so far been revealed in the survey of the Department of Commerce (taken in June), which showed an expected 9% increase in 1981 expenditures by American manufacturers (see charts on reverse for details).

These responses from companies must, of course, be regarded as preliminary since the year 1981 had not yet started at the time they were delivered. As always, future economic developments, which can only be guessed at now, will determine whether or not these plans will be fulfilled.

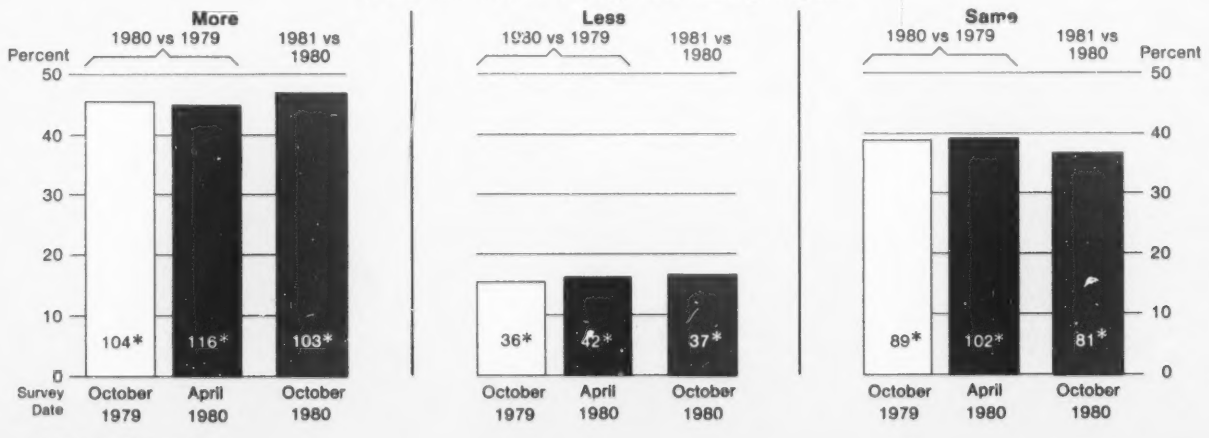
The ranking of the reasons for increasing 1981 investment are about the same as for 1980. Expanding into new—or maintaining old—markets were the top reasons offered for increasing expenditures in both years.

The ranking of the reasons for expecting declines in 1981 changed from those offered for 1980. "Major expansion completed last year" was the most frequently mentioned reason, as usual. But thereafter, relatively more emphasis was placed upon poor profit prospects and poor economic outlook abroad than before.

J. Frank Gaston

Manufacturers' Plans for Plant and Equipment Expenditures Outside the United States

Number and Percent of Companies Planning to Spend:

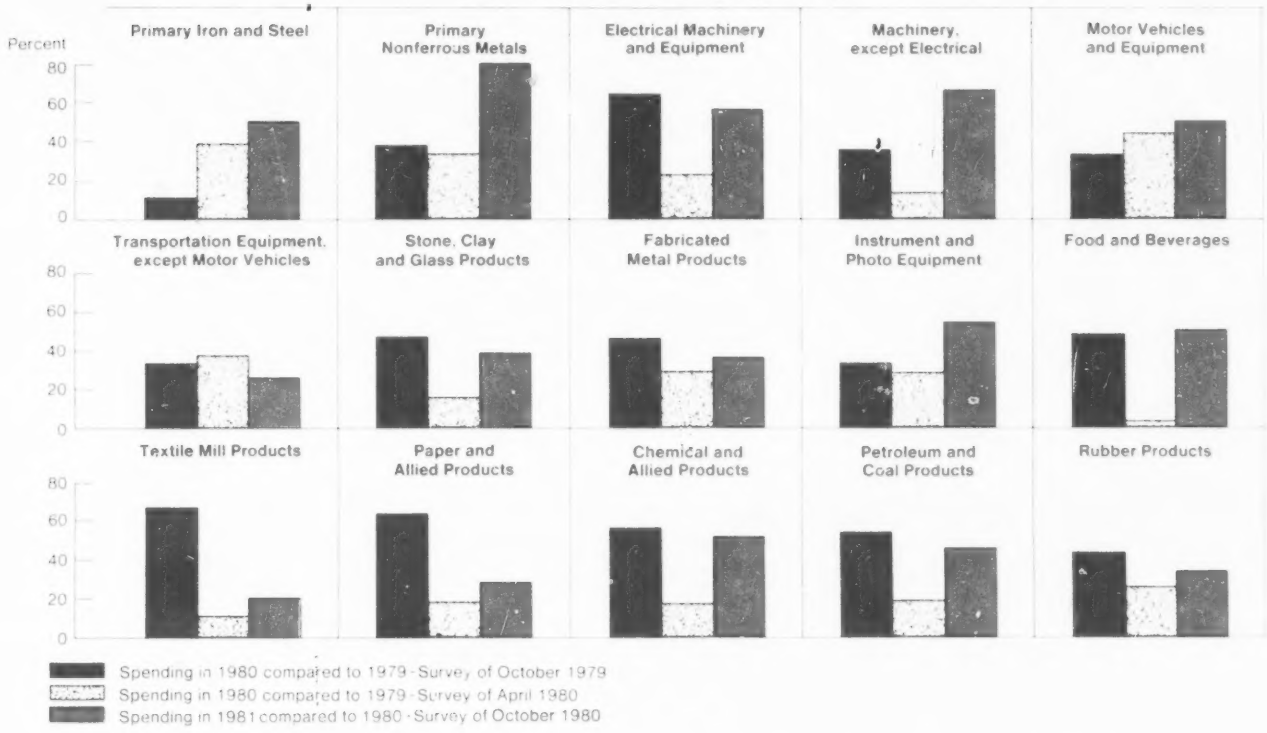


* Number of Companies

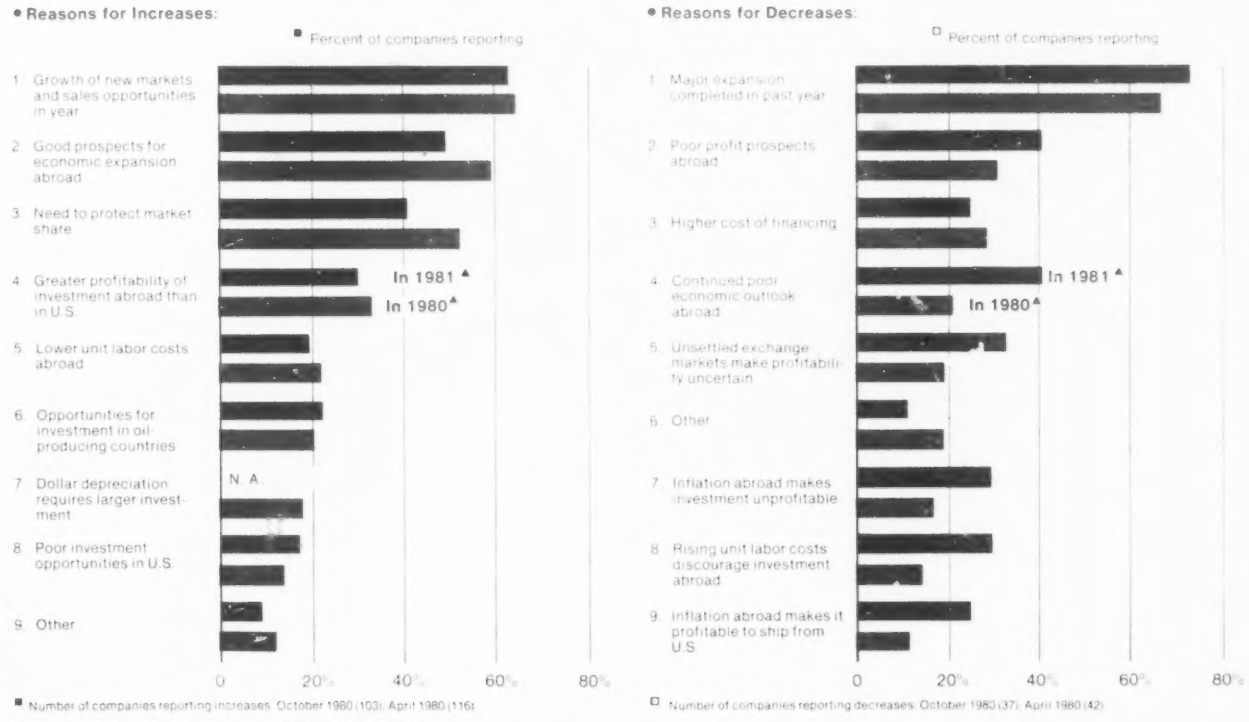
© 1981 The Conference Board, Inc.

Spending Plans for Plant and Equipment Outside the United States by Industry

Percent of Companies Planning to Spend More



Reasons for Plant and Equipment Expenditures Outside the United States--All Manufacturing


• Reasons for Increases:
■ Percent of companies reporting
1. Growth of new markets and sales opportunities in year
2. Good prospects for economic expansion abroad
3. Need to protect market share
4. Greater profitability of investment abroad than in U.S.
5. Lower unit labor costs abroad
6. Opportunities for investment in oil-producing countries
7. Dollar depreciation requires larger investment
8. Poor investment opportunities in U.S.
9. Other
In 1981 ▲
In 1980 ▲
N. A.
0
20%
40%
60%
80%
■ Number of companies reporting increases: October 1980 (103); April 1980 (116)
▲ Based on October 1980 survey
▲ Based on April 1980 survey
• Reasons for Decreases:
□ Percent of companies reporting
1. Major expansion completed in past year
2. Poor profit prospects abroad
3. Higher cost of financing
4. Continued poor economic outlook abroad
5. Unsettled exchange markets make profitability uncertain
6. Other
7. Inflation abroad makes investment unprofitable
8. Rising unit labor costs discourage investment abroad
9. Inflation abroad makes it profitable to ship from U.S.
In 1981 ▲
In 1980 ▲
0
20%
40%
60%
80%
□ Number of companies reporting decreases: October 1980 (37); April 1980 (42)

J. Frank Gaston, Editor
A bimonthly report from

THE CONFERENCE BOARD, INC.
845 Third Avenue, New York, N.Y. 10022
(212) 759-0900 Telex 234465 and 237282

THE CONFERENCE BOARD OF CANADA
25 McArthur Road
Ottawa, Ontario, K1L-6R3, Canada
(613) 746-1261

THE CONFERENCE BOARD IN EUROPE
Avenue Louise, 326 - Bte 48
B-1050 Brussels, Belgium
(02) 640 62 40 Telex 63635

R4105-17.9 B

THE CONFERENCE BOARD

Worldbusiness Perspectives No. 59
February, 1981

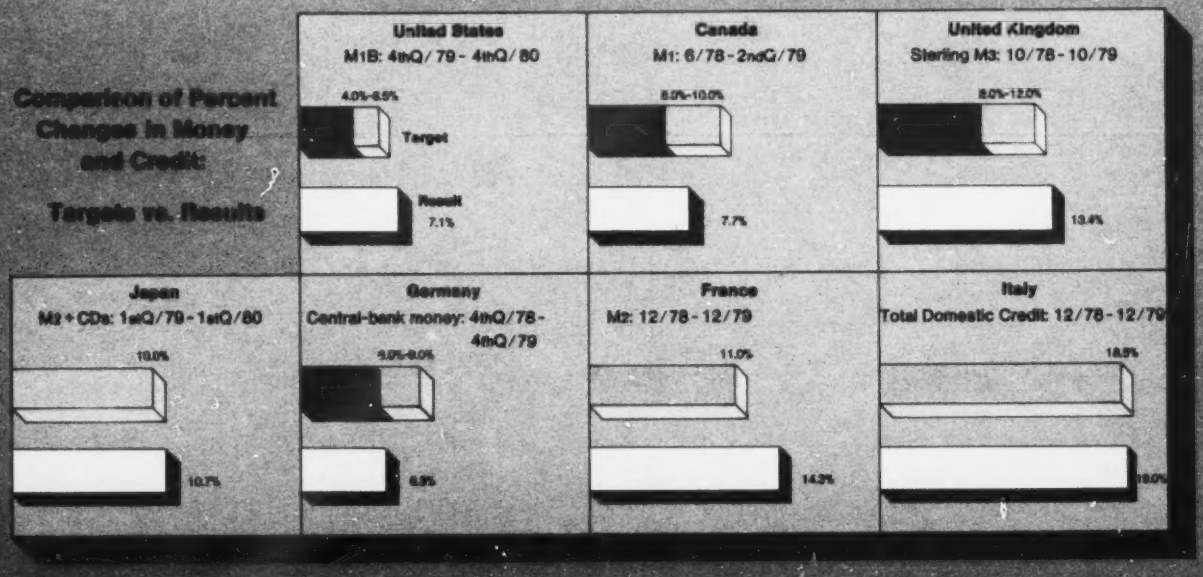
PROBLEMS IN PURSUING MONEY TARGETS
An International Comparison

In 1970, the United States started the decade by becoming the first major country to adopt targets of growth for money and credit. It has since been joined by a number of its trading partners, including Japan, the Federal Republic of Germany, France, the United Kingdom, Canada, Italy, Switzerland and the Netherlands (see Chart).

The importance of money and the necessity to reduce its growth over time to control inflation are evidently becoming more widely accepted. Serious debate continues, however, over both technical issues and broad policy issues, such as the extent to which countries should offset external shocks to their economies. The monetary policies adopted by central bankers are influenced by each of these issues—but, of course, not necessarily in the same way.

Country Targets

The targets adopted by individual countries are set with reference to different measures, ranging from the "monetary base" to such broad credit aggregates as "total domestic credit." Neither of these extremes, incidentally, is usually regarded as "money." Four of the countries express their growth targets in ranges; four as single figures; and the Netherlands' target—given by direction—is a ratio of the year's national income to M2 outstanding at the end of the year. Comparisons are



Note: M1, and M3 refer to money narrowly defined and consist mainly of monetary instruments that are used for transactions such as currency and demand deposits or close equivalents. M2 and M3 generally refer to progressively broader measures of money that include time and savings deposits with varying length of maturities as well as other measures that vary from country to country (such as money market mutual funds in the United States.)

Sources: Bank for International Settlements; The Conference Board.

© 1981 The Conference Board, Inc.

further complicated by the fact that one country, the United States, gives ranges for a multiplicity of targets—four money targets and one for bank credit as well.

To confuse matters even more, countries have shifted or dropped targets as their experience with them, or economic developments themselves, dictated. The Federal Republic of Germany, for instance, has moved away from a single target toward target ranges for central bank money. Meanwhile, congressional pressures have been building in the United States for the Federal Reserve to narrow its present target ranges of roughly 3 percentage points. A number of smaller countries have not been able to adopt targets at all because of the greater relative importance to them of exchange rates for their currencies. Switzerland abandoned its M1 target for 1979 because of exchange rate considerations, and has since adopted a monetary base target.

The targets adopted are means of attaining broader objectives and are not ends in themselves. The reaching for broader objectives leads to a certain tension in the use of targets, since they must be firm enough for conviction and yet sufficiently flexible so as to be consistent with each nation's broad goals.

One of the main objectives in adopting money targets is to signal—to the public and to the international community—the determination of the monetary authorities to fight inflation and inflationary expectations. The authorities thereby hope to discourage speculative financial policies such as excessive debt leveraging, the stockpiling of commodities in anticipation of price increases, and foreign exchange speculation. A closely related objective is to influence important wage and price decisions in the economy by serving notice that sharp wage and price increases are inconsistent with the money and credit objectives of central banks and, therefore, will not be validated.

Finally, another goal is to show that the battle against inflation is not a temporary one, but rather is one that will persist over a period of years. For instance, the United Kingdom has presented targets for the next several years, showing a reduction for each successive year. The reactions of the public will undoubtedly be influenced by its perceptions of the determination of the responsible monetary authorities to meet their targets which, in turn, are influenced by their past track records.

For many countries, a degree of skepticism on the part of the public should come no surprise, since the actual rates of growth of the respective "money" aggregates have exceeded the targets. In 1977 and 1978, actual rates of growth of central bank money and money narrowly defined (M1) exceeded target rates even in the Federal Republic of Germany and Switzerland—two countries that have been relatively successful in containing inflation to date.

A comparison of the rates of growth of money—either narrowly or broadly defined—would not, in itself, lead to an accurate ranking of each country's rate of inflation during the 1970's. Money (M1) in the United States, for example, grew less rapidly than it did in the Federal Republic of Germany or Switzerland (see Table).

Money Growth in Industrial Countries, 1970-1979*
(percent)

Country	*1970-73*	*1973-74*	*1975-78*	*1978-79*
United States	6.7	4.6	6.5	5.8
Japan	24.7	14.5	10.8	11.9
Germany, Federal Republic of	11.2	3.7	10.3	9.9
France	12.6	11.9	10.9	12.5
United Kingdom	13.2	3.4	16.7	13.3
Italy	20.8	19.7	20.6	23.2
Belgium	11.7	7.1	8.9	4.4
Netherlands	14.7	11.4	11.4	2.9
Denmark	9.3	15.3	13.1	14.4
Sweden	9.3	16.1	9.2	16.3
Canada	10.7	6.2	8.6	5.8
Switzerland	10.9	—1.9	7.0	11.3

* Average annual growth rates of money narrowly defined (M1).
Sources: International Monetary Fund, The Conference Board.

A comparison of each country's budget deficit—either federal or public sector—as a percentage of GNP, as well as the extent to which such deficits were monetized, would similarly be misleading in ranking a country's inflation performance. According to figures from the Bank for International Settlements, public-sector deficits in the United States averaged roughly 3.6 percent of GNP during the period 1975-1979, while those of the Federal Republic of Germany averaged roughly 4.1 percent of GNP.

During the 1970's, most of the major industrial countries experienced lower real growth than they did during the 1960's. Most of them also experienced higher rates of money growth and higher rates of inflation than during the preceding decade.

In the second half of 1980, money targets played a prominent role in the political sphere. Money growth in the United Kingdom, Sterling M3, exploded in July and August, as money rose 5 percent and 3 percent, respectively. These large increases at a time of high unemployment led to concern as to what would happen to an already weak economy if heavy emphasis would continue to be placed on limiting monetary growth to meet money targets. The government's monetary policy was questioned in a report by an all-party committee in late December, 1980, and led to a debate in the House of Commons.

Rapid rates of growth in money in the third quarter of 1980 led to similar concerns in the United States. On October 2, President Carter stated that the approach of the Federal Reserve was "ill-advised," and cautioned the Fed not to place too much emphasis upon money supply. Money supply targets are likely to remain an important issue in the United States and they are likely to receive careful scrutiny by the new Administration. These debates over the role of money targets will continue, no doubt, in other major industrial countries as well in the years ahead.

Quite independent of the broader political issues, central bankers face technical problems in pursuing money targets that are not widely appreciated. As an example, some of the problems that exist in administering monetary growth targets for the United States are examined below, but many of the same problems exist in other countries where they are further complicated by the relatively greater reliance on international trade and exchange rates.

Setting U.S. Targets

In the United States, the Federal Reserve sets targets (in ranges) for each measure of money and credit for a one-year period, and it sets three-month targets as well. Since a procedural change in October, 1979, it now places greater emphasis on bank reserves and allows wider swings in short-term interest rates. However, technical experts question whether the Federal Reserve's ability to hit its one-year targets will be any better under the new procedures.

Several problems in U.S. money targets were highlighted by developments in 1980. First, there remains the problem that there is in practice no clear definition of money. In February, 1980, the Federal Reserve redefined the monetary aggregates to take account of new financial developments and practices—such as money market funds and interest-bearing checkable deposits at both banks and other financial institutions. This is not the first such revision. There were, for instance, major revisions in money measures to correct for international transactions in the late 1960's and early 1970's.

Second, there clearly are problems in pinpointing the appropriate ranges for each of the Fed's targets. In a controversial move in late July, 1980, Chairman Volcker of the Federal Reserve did not, initially, provide Congress with the ranges for the 1981 targets. When he did provide the targets a week later, in a letter to Senator Proxmire, Mr. Volcker explained that the Fed's general intent was to reduce three of the money targets by 0.5 percentage points (and to maintain the same ranges for two other targets). The target for currency and demand deposits (M-1A) was reduced from a range of 3.5 to 6 percent in 1980 to a range of 0 to 2.5 percent in 1981, while the target for a somewhat broader measure (M-1B) rose from 4 to 6.5 percent to 5 to 7.5 percent. This curious arithmetic, where 3.5-0.5 = 0, and where less can mean more, is due largely to an institutional change in 1981—the introduction of NOW accounts nationwide. These accounts, by definition, are included in M-1B but not in M-1A; and their growth is expected to reduce the growth of demand deposits since NOW accounts are essentially demand deposits on which interest is paid. This example shows the problems that could arise in taking too literally suggestions that the growth of money should be held steady or reduced by 1 percent a year, as some have advocated.

The Federal Reserve can only estimate the effect of institutional changes. This raises the broader issue as to how well the nation's money managers—or anyone else—can really judge the appropriate monetary targets that are consistent with desired economic objectives.

There are, in addition, other changes taking place. Each year, for instance, a larger number of companies are learning new ways to economize on "cash" balances, and improvements continue to be made in payments technology. Also, Conference Board and other studies suggest that, for the next several years,

corporate clients will place relatively greater weight on compensating banks with fees and less weight on balances. These developments will tend to lower the amounts of money that are associated with given rates of change in economic activity.

There are further complicated questions as to how to relate the rapidly growing Eurodollar market to U.S. money supply and economic activity. Also, since the dollar is still the world's major trading currency, U.S. companies and foreign holders of dollars may both use balances in the United States to support world trade transactions that have nothing to do with domestic U.S. economic activity.

Income Velocity

The Federal Reserve is also aware that income velocity (GNP or GDP divided by each money measure) changes from year to year and over the business cycle. There has been a tendency for the velocity of money (narrowly defined) to rise during recovery periods and, since 1960, to rise at more rapid rates than in the preceding cycle. In setting its targets, the Federal Reserve has to estimate the rate at which velocity will rise. This judgment has very important implications for business in 1981. At present, "Fed-watchers" differ as to whether the reductions in money targets for 1981 are or are not restrictive. Those who think they are restrictive are assuming that velocity in 1981 will not accelerate as rapidly as it did in 1975, the first year of a recovery period.

Even if there were to be a single measure of money, and even if there were no institutional changes taking place, the relation of money to economic activity would still be clouded by the fact that money is not simply used for GNP-related transactions. Rather, it is also used to transfer ownership of already existing real assets, such as real estate, and existing financial assets, such as stocks and bonds. From the crude measures available, the use of money for these non-GNP purposes does not appear to bear a constant relation to its use for GNP transactions, either cyclically or over longer periods of time. The choice of monetary targets implicity makes assumptions about money's behavior for these non-GNP purposes. This is not to suggest that the Fed itself has GNP myopia. But there is room here for serious empirical work that would further reduce the "mysterious" behavior of income velocity.

Vincent G. Massaro

J. Frank Gaston, Editor
A bimonthly report from

THE CONFERENCE BOARD, INC.
845 Third Avenue, New York, N.Y. 10022
(212) 759-0900 Telex 234465 and 237282

THE CONFERENCE BOARD IN CANADA
25 McArthur Road
Ottawa, Ontario, K1L-6R3, Canada
(613) 746-1261

THE CONFERENCE BOARD IN EUROPE
Avenue Louise, 207 Bte 5
B-1050 Brussels, Belgium
(02) 640 62 40 Telex 63635

R4105-17.10 A

THE CONFERENCE BOARD

Worldbusiness Perspectives No. 60
April 1981

INTERNATIONAL INTEREST RATE PATTERNS:
A Decade of Change

Interest rate patterns in major industrial countries show three general characteristics that sharply distinguish them from the period prior to the early 1970's. First, nominal interest rates are well above those of the previous period. Second, the differences in levels between countries are much greater today. Third, interest rates are now much more volatile.

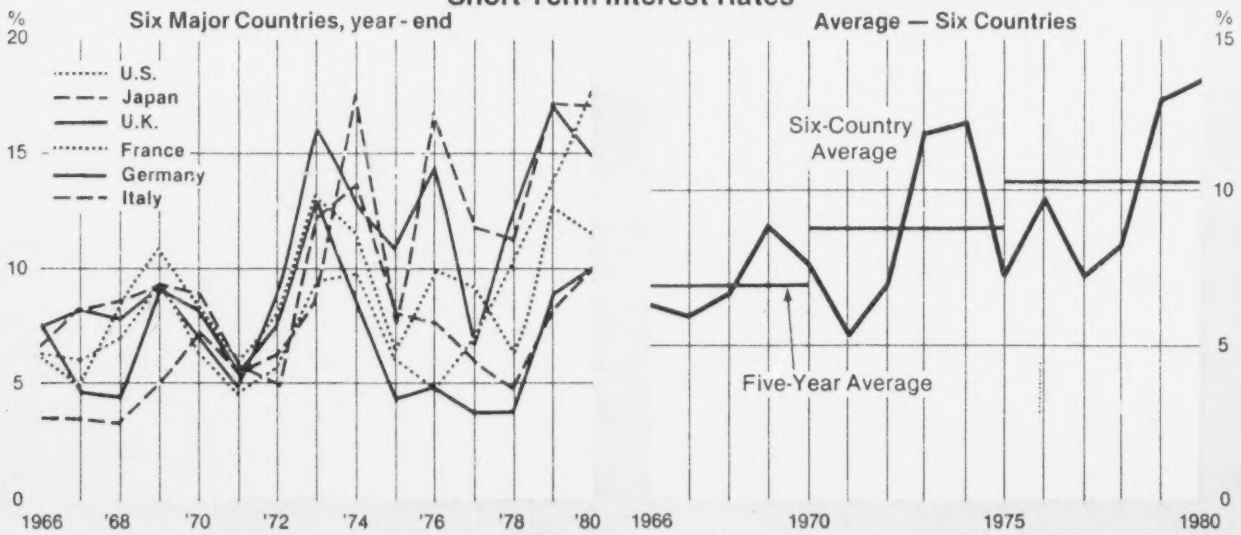
While these features of interest rates are clearly identifiable, their explanation and their significance are not as clear-cut. Some assessment, however, is possible, resting upon economic and institutional developments of the last ten years.

Transformation in International Finance

During the last decade, the international financial scene has undergone a pronounced transformation. Spurred by growing inflation, floating exchange rates, and the explosion of oil prices, the behavior patterns of investors and borrowers have changed radically. Moreover, substantial new developments have occurred in the institutional framework of financing. As a consequence, the credit markets of the industrialized world have become more efficient, thereby accelerating the trend toward expansion of the money supply and increases in the velocity of money in circulation. There can be no doubt that the pronounced inflationary trend of the last years has caused a radical transformation in the supply of and the demand for capital. On the one hand, the incentive to save is decreasing; on the other hand, growing speculation is creating highly destablizing international flows of funds, thus increasing global economic imbalances.

Chart 1

Short-Term Interest Rates



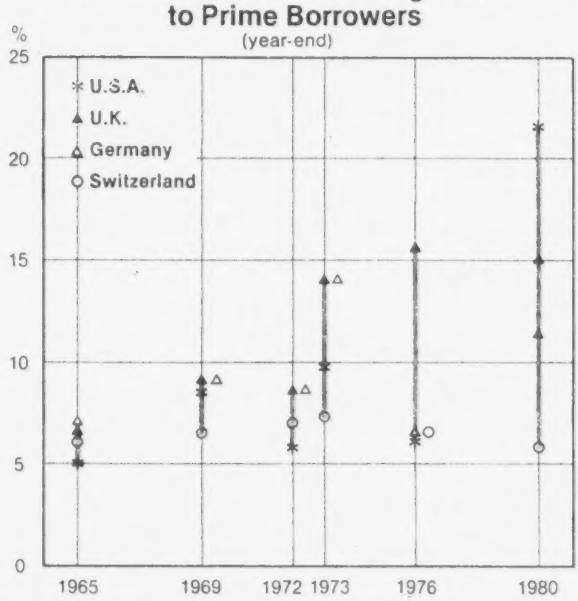
© 1981 The Conference Board, Inc.

Closely linked to these trends—in part contributing to them, in part resulting from them—is the transformation that has occurred during the last ten years in the international pattern of interest rates. First of all, the general level of international interest rates has been moving steeply upward (Chart 1). While in the early 1960's the average level of short-term money-market rates for the six largest industrial countries fluctuated in the neighborhood of 3 to 4 percent, it climbed to 7.5 percent in 1970. At the transition to the 1980's this six-country averge reached 13.5 percent. This upward pressure is due, in part, to the lower rate of savings in the Western world. The principal reason for the increase in the interest-rate level, however, is the changing behavior of savers and investors.

In general, people make economic decisions by taking into account all available information that has a significant bearing on the future consequences of those decisions. Times of relatively stable prices and interest rates allow market participants to calculate in current dollars. In other words, they are not inflation-conscious, a phenomenon that economists call the "money illusion." In the recent past, however, a process of rethinking has taken place in the face of the rapidly decreasing purchasing power of money. Today, borrowers and lenders have learned that they must consider the effect of inflation on future loan repayments. Lenders seek to protect the purchasing power of the funds lent, while borrowers are willing to pay a higher rate if they expect inflation to enable them to repay the loan with cheaper dollars. That means that market participants—especially professionals—nowadays have become much more "real terms" conscious; they deduct the expected inflation rate from the nominal or market rate of interest. Thus, because of inflation and of inflationary expectations, the market interest rate can differ considerably from the "real" rate (Chart 3). In today's inflationary environment, inflationary expectations play a large role in the determination of interest rates.

Chart 2

Commercial Bank Lending Rates to Prime Borrowers



Therefore, most of the increase in the general level of market rates in recent years has been due to rising inflationary expectations. Since market participants tend to extrapolate past experience in order to estimate future rates of inflation, interest rates in major industrialized countries have gone up sharply in response to a steady and substantial decline in purchasing power. Until there is a continuing reduction in expectations of inflation, significant and long-lasting interest rate declines are unlikely. That is the lesson of the past 15

Chart 3

Yields on Long-term Domestic Corporate Bonds

* Market (nominal) yield less average annual rate of change in consumer prices over five previous years

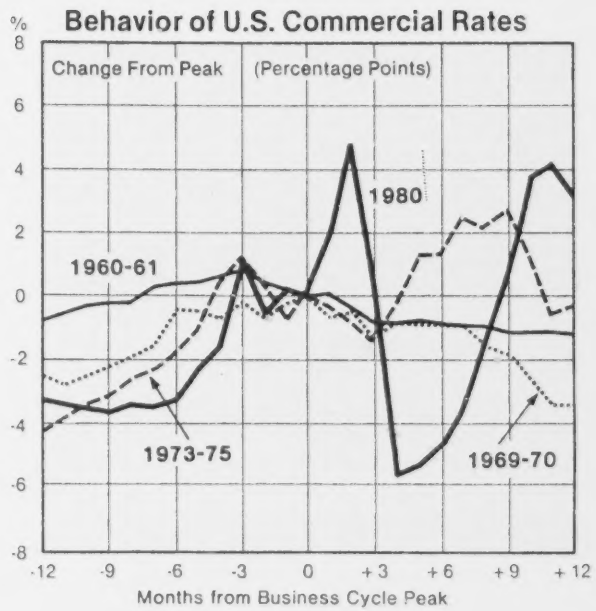
years. Today, the investor is expecting and receiving a real return that is often higher than the 2 to 3 percent level which, over the long run, has been considered the average real yield on financial assets in major Western countries. Thus, as professionals become more and more sensitive to inflation, the significance of the money illusion is clearly vanishing.

Widening International Rate Differentials

Among industrialized nations, there has long been a remarkable variation of attitudes toward inflation. Some countries—notably those of the English-speaking world—have tended to be rather casual, some would say indifferent. Others, such as Germany and Austria—which have had first-hand experience with destructive inflation—have long demonstrated a high degree of self-discipline. As a consequence, the inflation differentials among major countries have widened to unprecedented levels. This fact, together with the increased tendency toward "real-term" thinking, have led to another transformation in the international interest rate pattern: Since the demise of fixed exchange rates in 1973, a widening of the international interest rate differentials has become clearly visible (Chart 2).

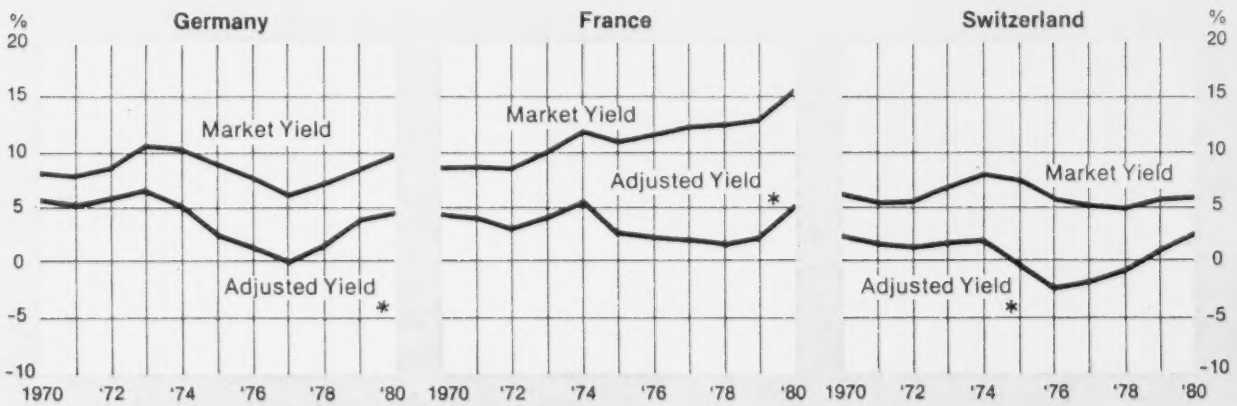
Whereas under stable exchange rates interest rate differentials between the major currencies generally kept within the range of 1 to 3 percentage points, in recent times they have widened to the startling magnitude of 10 to 15 percentage points. In this context, differences among countries in the conduct of monetary policy—that is, mainly in the use and the impact of the respective policy instruments—play an important role. Only countries that have demonstrated monetary discipline and, therefore, have been successful in curbing monetary growth and inflation could maintain relatively low interest rates over the time. In

Chart 4



Switzerland, to take the extreme, despite the recent upsurge in interest rates, mortgage money in this inflationary period is still available at 5 to 5½ percent and the money supply has been growing at a very slow pace.

Furthermore, the national interest rate disparities become more pronounced because of speculative international capital movements. Countries that have been suffering from outflows of funds have, therefore, been forced to raise their rates to protect their currencies. The recipient countries, on the other hand, have found themselves in the comfortable position of getting by with lower rates. The most recent example of this phenomenon is the dramatic rise of the overall interest rate level in Germany and Switzerland. In order



to stop the outflow of capital and to reduce the inflationary impact of the weakening of their currencies, these two countries were forced to apply their monetary brakes vigorously. As a consequence, the three-month rates for Euro-francs soared in the first quarter of 1981 by not less than 4 percentage points, whereas the respective increase for Euro-marks even reached more than 5 percentage points.

Under these circumstances, nominal interest rate differentials no longer provide a reliable criterion for financing policy. A more valuable guide is the real rate of return. On this basis, funds would be invested in countries providing high real yields, while borrowing would be undertaken where real interest rates are low or even negative.

Increasing Volatility

Another, more recent development is the extreme volatility of interest rates. In the relatively stable period prior to the 1970's, the swings of short-term interest rates from the trough to the peak of a business cycle covered a span of 2 to 3 percentage points. Today, the fluctuations are far bigger. In the United States, for example, in the last two years we have witnessed interest-rate swings of unprecedented dimensions, far exceeding the range of expectations of almost all observers (Chart 4). The prime rate, to take a popular measure, rose sharply in the early part of 1980 to the neighborhood of 20 percent, then dropped steeply to about 11 percent a few months later with the onset of recession and the dwindling of aggregate credit demand. Before year-end, the prime abruptly turned upward again, with the upsurge accelerating until the rate reached record levels of 21.5 percent. This phenomenon of increased interest rate volatility, moreover, has occurred in other countries as well, as the examples of Germany and Switzerland demonstrate.

These hectic movements are due not only to the turmoil in exchange-rate markets. To a large extent, they also reflect the uneven conduct of monetary policy in most countries. In times of inflationary overheating monetary restraint is exercised with vigor. But as soon as there are signs of slowing price increases and of recession, the restrictions are relaxed in order to stimulate economic activity and employment. This "stop-go" economic performance of many countries and the associated effects on credit demands and investor expectations explain a large part of today's extreme interest rate swings. But continued high rates of inflation, and the uncertainties in lender and borrower attitudes that they create, are surely also part of the cause. Interesting enough, it obviously was the increased uncertainty as to the relationship between interest rates and the demand for money and credit that led the Federal Reserve in late 1979 to shift the emphasis in its operations from market-oriented interest-rate indicators to direct monetary growth targeting.

Effects of New Interest Rate Patterns

In summary, over the last ten years or so three main changes have occurred in the international interest-rate pattern: A steady trend toward higher rates; greater international disparities among rates; and a higher volatility of rates. Undoubtedly, these new and generally unfavorable developments are having wide implications for international finance. In general, they threaten serious deterioration of financial and economic institutions, such as the bond markets and financial intermediaries. Furthermore, they have deeply affected the investment behavior of private and institutional savers. There is an increasing tendency toward short-term commitments in order to be able to adapt one's strategy as rapidly as possible to changes in interest rates. As a consequence, a widening gap is being created between the maturity of the funds offered and the need of the economies for long-term capital.

Today, a consensus is developing that the answer to this serious problem must be a policy of rigorous action on national and international levels, the primary focus being on a tough and prolonged anti-inflation therapy based on the control of the money supply. This does not mean, of course, that other economic reforms are unnecessary. But without the decisive long-term fighting of the inflationary disease it might well be impossible—in the opinion of most observers—to maneuver the international interest rate structure back to a less erratic and healthier track, thereby restoring a more rational basis for international capital movements.

Joerg Neef*

*Economist, Credit Suisse Zurich, currently on loan to The Conference Board.

J. Frank Gaston, Editor
A bimonthly report from

THE CONFERENCE BOARD, INC.
845 Third Avenue, New York, N.Y. 10022
(212) 759-0900 Telex 234465 and 237282

THE CONFERENCE BOARD IN CANADA
25 McArthur Road
Ottawa, Ontario, K1L-6R3, Canada
(613) 746-1261

THE CONFERENCE BOARD IN EUROPE
Avenue Louise, 207 Bte 5
B-1050 Brussels, Belgium
(02) 640 62 40 Telex 63635

THE CONFERENCE BOARD

Worldbusiness Perspectives No. 61
June 1981

FOREIGN CAPITAL EXPENDITURES BY AMERICAN COMPANIES:
A Slight Hesitation for 1981

American manufacturing and petroleum corporations appear to be trimming their 1981 plans to make outlays for plant and equipment outside the United States, according to the latest survey taken by The Conference Board in April, 1981. About 43 percent of the companies replying indicated an intention to raise their expenditures over the 1980 level. This represents a decline from the 47 percent who said that they expected to boost 1981 expenditures over the 1980 level when they were queried in the prior survey in October, 1980.

The petroleum industry constitutes an important exception to the general observation that the April, 1981, survey reveals more restraint in the outlook for plant and equipment expenditures abroad. In that industry, nearly 68 percent of the companies indicated that they plan to raise 1981 expenditures levels above those for 1980. This response indicated considerably more activity than their response to the October survey, when 46 percent said that they expected 1981 expenditures to be higher.

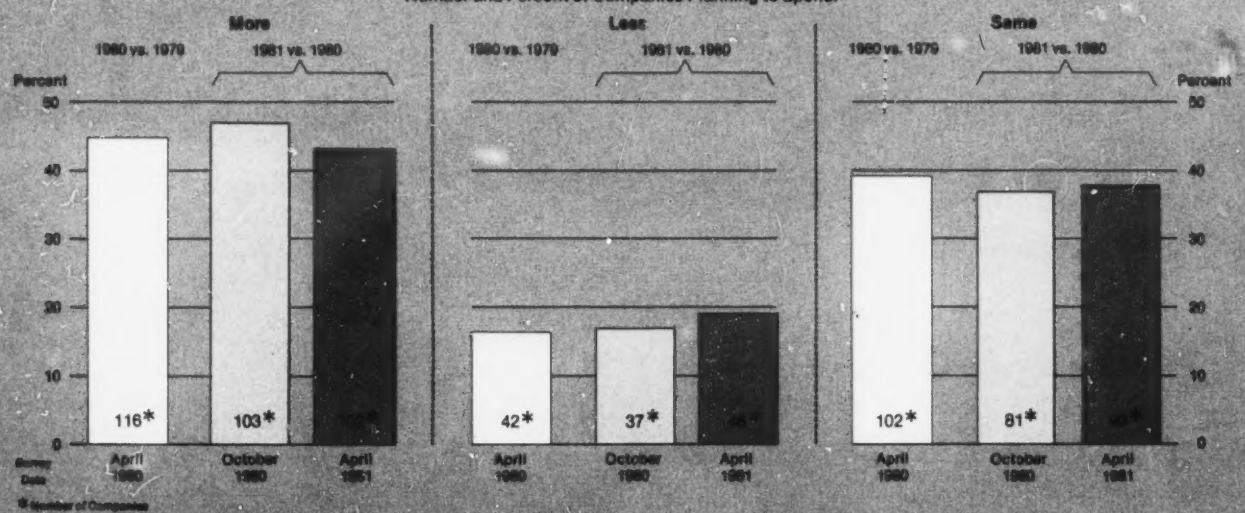
No estimates of money expenditures were collected in The Conference Board survey, but the one conducted by the United States Department of Commerce in December, 1980, shows that expenditures on plant and equipment abroad are expected to increase by about 14 percent in 1981 over 1980 levels. This rise is due largely to the expansion plans of petroleum companies that plan to raise their expenditures by 25 percent—in contrast to a rise of only 7 percent for manufacturers.

For manufacturing and petroleum companies combined, the 1981 plans represent a cutback from the 1980 record. With both segments showing substantial increases, the combined 1980 expenditures were up by 25 percent over 1979.

J. Frank Gaston

Manufacturers' Plans for Plant and Equipment Expenditures Outside the United States

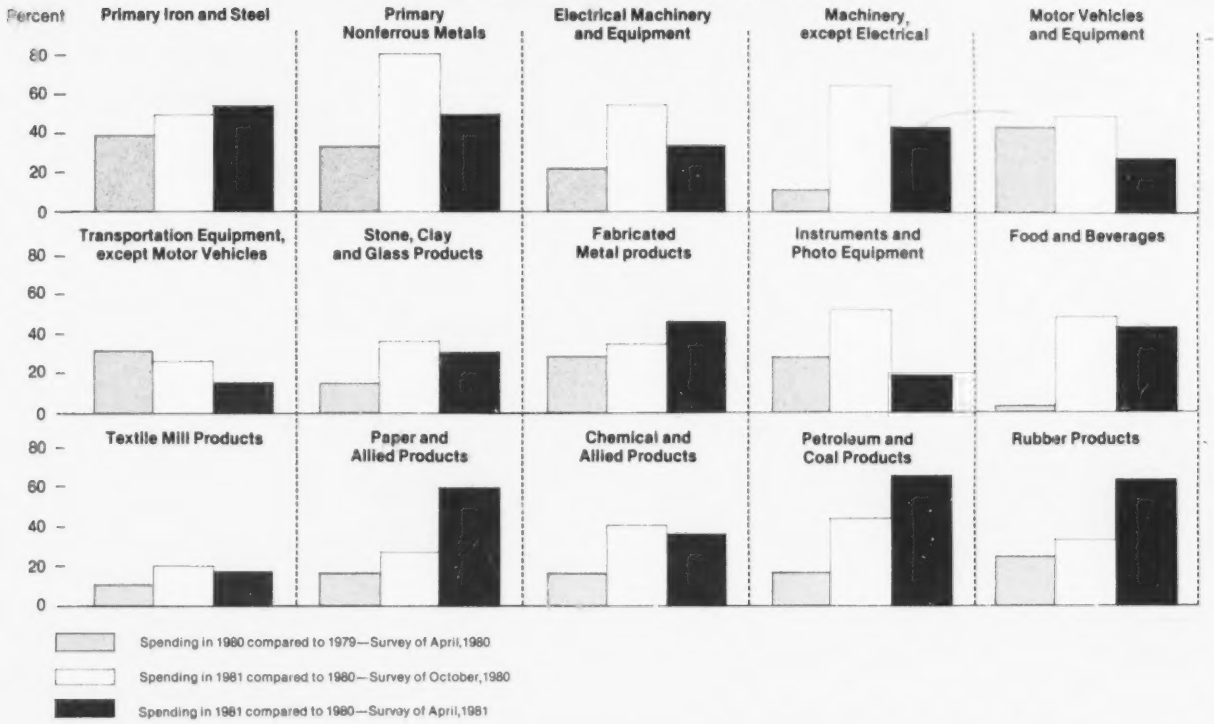
Number and Percent of Companies Planning to Spend:



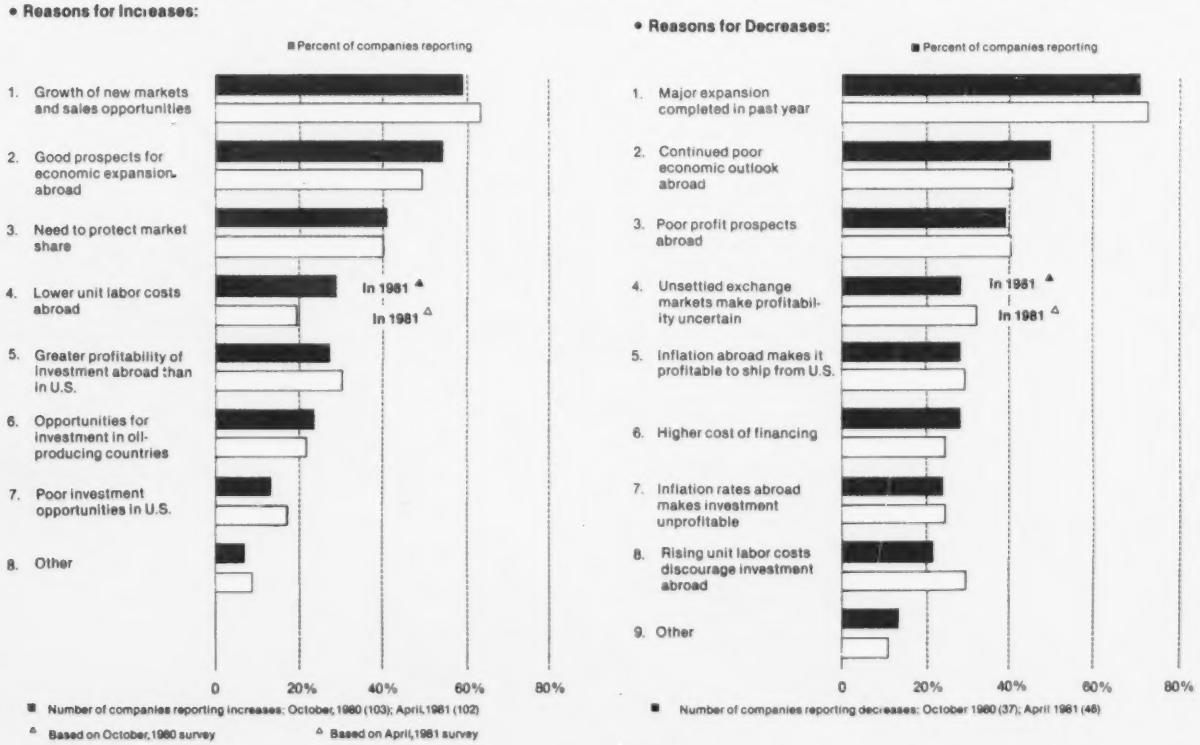
© 1981 The Conference Board, Inc.

Spending Plans for Plant and Equipment Outside the United States by Industry

Percent of Companies Planning to Spend More



Reasons for Plant and Equipment Expenditures Outside the United States—All Manufacturing


• Reasons for Increases:
Percent of companies reporting
1. Growth of new markets and sales opportunities
2. Good prospects for economic expansion abroad
3. Need to protect market share
4. Lower unit labor costs abroad
5. Greater profitability of investment abroad than in U.S.
6. Opportunities for investment in oil-producing countries
7. Poor investment opportunities in U.S.
8. Other
In 1981 ▲
In 1981 △
0
20%
40%
60%
80%
■ Number of companies reporting increases: October, 1980 (103); April, 1981 (102)
▲ Based on October, 1980 survey
△ Based on April, 1981 survey
• Reasons for Decreases:
Percent of companies reporting
1. Major expansion completed in past year
2. Continued poor economic outlook abroad
3. Poor profit prospects abroad
4. Unsettled exchange markets make profitability uncertain
5. Inflation abroad makes it profitable to ship from U.S.
6. Higher cost of financing
7. Inflation rates abroad makes investment unprofitable
8. Rising unit labor costs discourage investment abroad
9. Other
In 1981 ▲
In 1981 △
0
20%
40%
60%
80%
■ Number of companies reporting decreases: October 1980 (37); April 1981 (48)

J. Frank Gaston, Editor
A bimonthly report from

THE CONFERENCE BOARD, INC.
845 Third Avenue, New York, N.Y. 10022
(212) 759-0900 Telex 234465 and 237282

THE CONFERENCE BOARD IN CANADA
25 McArthur Road
Ottawa, Ontario, K1L-6R3, Canada
(613) 746-1261

THE CONFERENCE BOARD IN EUROPE
Avenue Louise, 207 Bte 5
B-1050 Brussels, Belgium
(02) 640 62 40 Telex 63635

8/11 R410 - 17.12 A

THE CONFERENCE BOARD

Worldbusiness Perspectives No. 62
August 1981

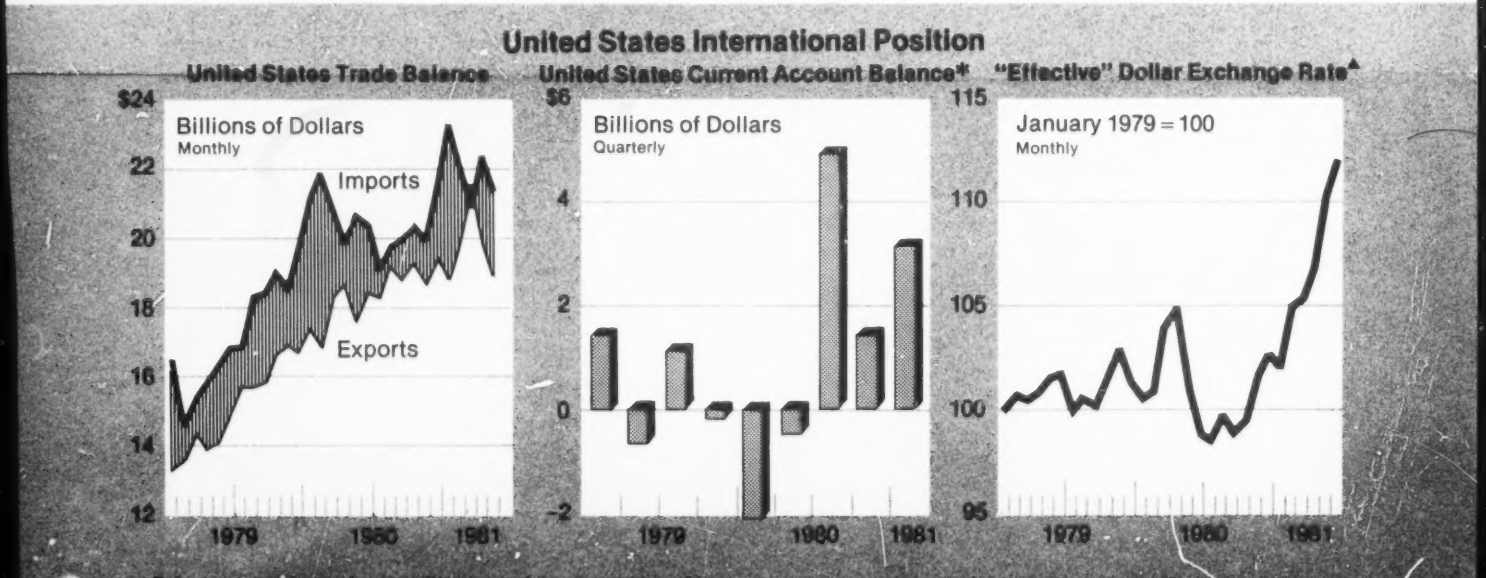
BEST AVAILABLE COPY

THE RESURGENT DOLLAR
A Look at Fundamentals

The years 1980 and 1981 to date are likely to be remembered as a period of exceptional strength for the dollar and of a greatly improved U.S. external position. While in the late 1970's almost everything seemed to conspire against the dollar, now most elements seem to have moved in a favorable direction for the dollar. The chief economist of a New York bank remarked in June that the whole sentiment regarding the dollar had changed, including fundamental economic and political factors. And a German banker was quoted by *The Wall Street Journal* to the effect that "one doesn't hear too much negative these days out of the United States; Mr. Reagan seems to be getting his house in order."

It has been customary to attribute the recent strength of the dollar to high U.S. interest rates. As is well known, these have caused considerable unhappiness among European and Japanese policymakers and businesses, since they have sharply increased the attractiveness of the dollar and thereby tended to weaken other currencies. High U.S. interest rates have also forced monetary authorities abroad to maintain higher interest rates than warranted by their own domestic economic conditions. Yet, the dollar fell in 1977-78 despite the fact that U.S. interest rates then were also higher than those abroad. Thus, other factors have been at work as well and, as Federal Reserve Chairman Paul Volcker pointed out at a mid-July hearing before the Joint Economic Committee of Congress, it would be a mistake "to attribute the appreciation of the dollar since December primarily to interest rates."

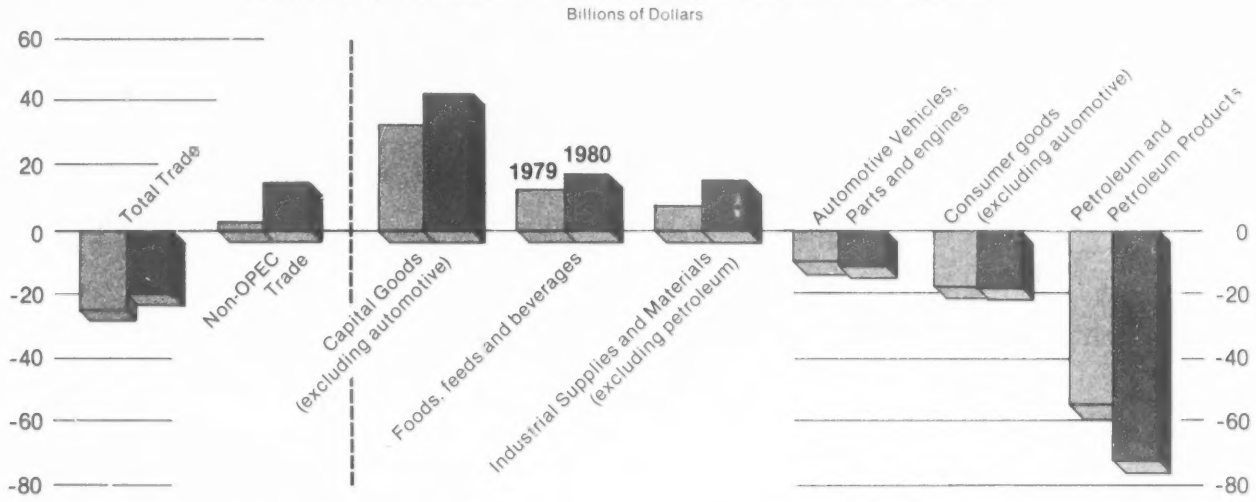
An important part of that appreciation has mirrored the recent weakness in other major currencies as a result of political events. There can be no doubt that the fear of a possible Soviet move into Poland has had an adverse effect on the German mark, and that the election of a Socialist government in France in May has



*Balance on goods, services, remittances and government transfers.
▲Changes in dollar rate vis-à-vis 15 major currencies, weighted by bilateral manufactures trade in 1978.

© 1981 The Conference Board, Inc.

Trade Balance--Overall and by Major End-Use Categories



weakened the French franc. What this scenario suggests is that, even if the U.S. authorities yielded to foreign entreaties to shift the mix of their monetary and fiscal policies so as to lower domestic interest rates, the relative strength of the dollar might not be affected to any great degree.

Oil and U.S. Externai Accounts

The U.S. payments deficits of the late 1970's have often been attributed, in a simplistic way, to the "oil problem"; that is, to the fact that the United States was importing an increasing percentage of its domestic oil requirements. Similarly, in the mind of the public, the recent improvement in the country's international position has to some extent been tied to lessening oil pressures and lower oil prices. The actual situation, however, has been somewhat more complex.

Immediately after the first oil shock of 1973-74, the oil-importing countries' combined payments deficit, which mirrored the first massive OPEC surplus, was shared among virtually all oil importers—both industralized and developing. By 1975, the recession in the industrial world had reduced the industrial countries' payments deficits and increased the pressure on the developing countries. With the uneven recovery of 1976-78, however, the payments imbalances came to be concentrated among the industrial countries. By 1978, the largest single imbalance was a huge U.S. current- account deficit of $13.5 billion, roughly equal to that year's entire OPEC surplus.

Adjustment to the second oil shock of 1979-80, by contrast, has been considerably less painful. A major reason has been the sharp decline in oil consumption in the industrial countries and, to a lesser extent, the steady rise in non-OPEC oil supplies. Oil consumption in the industrial world fell by 7 percent in 1980 and, according to estimates by Morgan Guaranty Trust Company, may decline by another 4 percent this year. This would make for a reduction in consumption of some 4.5 million barrels per day between 1979 and 1980. This decline is 45 percent greater than that which occurred after the first oil price increase—even in the face of somewhat better economic performance in the industrial countries now.

The United States alone is responsible for about half of the 1980-81 drop in these countries' oil consumption and for over 40 percent of the decline in their net oil imports. This contraction reflects mainly higher domestic oil prices in the United States, including the effects of decontrol, and not merely slower growth in economic activity.

But in other respects, the United States also is in a more favorable position than other countries in meeting higher oil costs. Unlike Germany and Japan, for instance, it has not had to rely exclusively on increases in its manufactured goods exports to offset rising oil import bills. Rather, increased U.S. oil import costs were largely offset by improvements in the trade balance in agricultural products and raw materials, as well as in the balance of so-called invisibles (mainly overseas earnings of U.S. corporations.)

Gains in Nonoil Trade

Just how strong were these gains in various nonoil categories? In 1980, U.S. exports of manufactured goods increased by 24 percent—more than twice the growth in manufactured imports. To a large extent, this surge reflected the growth in exports of capital goods

proper. This category comprises about half of the manufactures' export total and traditionally has been the mainstay of U.S. manufactures trade. Even if overall U.S. exports should do somewhat more poorly this year, further gains are foreseen in such products as computers, electronic components, and oil-drilling and telecommunications equipment.

Another area of strong growth last year was in manufactured industrial upplies—products such as chemicals, paper and aluminum. These categories are expected to show sharply diminished growth this year, reflecting both sluggish economic activity abroad and greater sensitivity to higher prices, in terms of foreign currencies.

Among other nonagricultural exports, coal shipments recorded one of the largest increases. These exports were valued at $4.5 billion in 1980, a 36 percent increase over 1979. They would have been even larger, but for the well-publicized delays at major U.S. coal-exporting ports. This strength in foreign demand for U.S. coal reflects the rapid conversion to coal-fired electrical power-generating facilities in Europe, and adverse developments in major competing countries, such as a coal strike in Australia and political events in Poland.

Agricultural exports were also a strong contributor to the U.S. trade accounts in 1980 and are expected to do likewise this year. It is estimated that farm exports will expand again—possibly by as much as 20 percent—to near $50 billion, somewhat above last year's 18.5 percent growth (to a total of $42 billion). In contrast to a decade ago, when Japan was the only foreign market taking as much as $1 billion in U.S. farm products, there are now 11 countries in that category. Together, these accounted for $24 billion—or nearly three-fifths—of total agricultural shipments, with some of the most dramatic gains going to newcomers such as Mexico and China.

The gains in U.S. nonoil trade can be examined in another way, too. One can strike a trade balance that excludes not only oil imports, but total trade with OPEC as well, since the oil-exporting countries would not have been able to sustain their fairly high purchases from the United States without the benefit of oil revenues. On that basis, 1980 emerges as the second year in a row during which the United States achieved a surplus—$14 billion—in its trade with the non-OPEC world. For the first four months of 1981, such trade showed a $4.1 billion surplus.

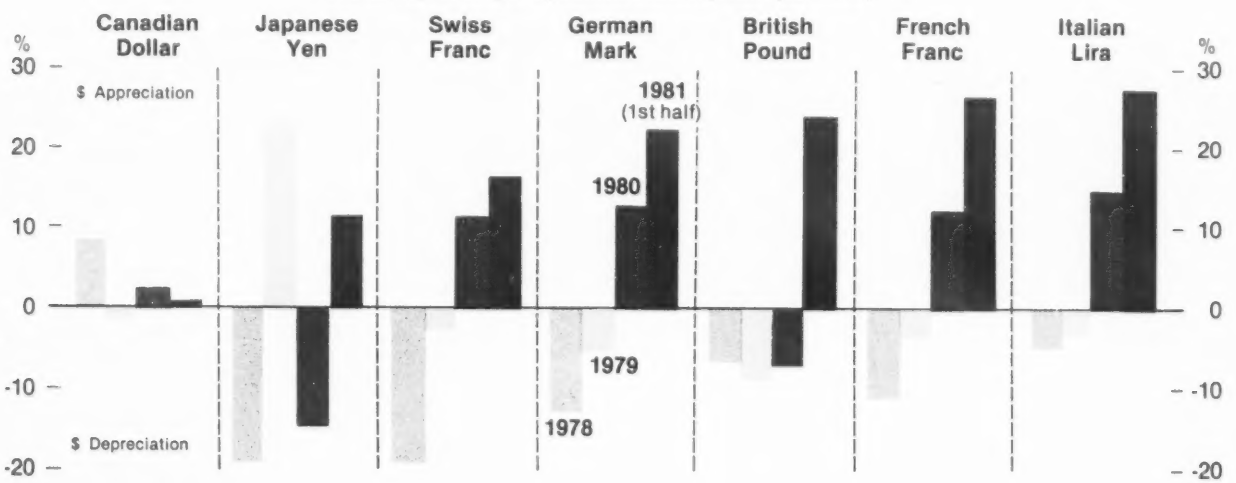
Implications of a Stronger Dollar

The recent strengthening of the dollar easily contains the seeds of its own reversal. Just as the dollar depreciation of 1977-78 established the conditions for the subsequent improvement in the U.S. trade and current-account position in 1979-80, so the dollar appreciation of 1980-81 is likely to show up—after a lag variously estimated at between one and two years—in reduced U.S. exports and enlarged U.S. imports.

Conversely, as foreign currencies depreciate vis-à-vis the dollar, foreign exports (as well as goods on domestic markets) once more become more price-competitive. This already has become evident in the order books of German manufacturing firms, whose foreign orders and increasing exports appear to have put an end to the slump in the country's economic activity. One major German steel company reportedly found that foreign business pushed up its orders by 37 percent in the first

Foreign Exchange Value of the Dollar

(Percentage Changes in National Currency Units per Dollar)



A Tale of Two Currencies

Italy has been the country hardest hit by the strengthening dollar. Not only has the dollar appreciated more against the lira than against any other major currency, but the structure of Italy's foreign trade makes this particularly burdensome. While traditional Italian exports—such as textiles, clothing and shoes—go primarily to other European countries, most of its basic imports—oil and other raw materials—are priced in dollars.

In 1980, when the lira ranged between 820 and 930 per dollar, about 40 percent of total Italian imports of $85 billion had to be paid for in dollars. The oil import bill alone came to over $17 billion.

It has been estimated that, with an identical volume of imports and unchanged import prices, every additional 100 lire decline against the dollar will raise the domestic price level by 1 percent. The automatic cost-of-living indexing system for wages will boost that increase by a further 0.5 percent. By late July, the lira had dropped to 1,225 per dollar.

five months of the year. On the other hand, countries with depreciating currencies will also see a corresponding increase in the cost of their dollar-denominated imports, such as oil and other basic commodities, adding to inflationary pressures (see box).

Moreover, if for the next year or so the U.S. economy is going to grow, if not fairly rapidly, at least at a somewhat brisker pace than the other major industrial countries, the U.S. trade and payments accounts are bound to deteriorate again. But it should also be kept in mind that the so-called elasticity of foreign demand for U.S. products—that is, changes in foreign purchases of U.S. goods in response to changes in their price—is smaller than the corresponding elasticity of U.S. demand for foreign goods. Food and agricultural products and high-technology items make up a much higher proportion of U.S. exports than of imports, and these are bought less for reasons of price than because of need or for their technology content and quality. Consumer goods, which are much more price-sensitive, account for a larger proportion of U.S. imports than exports.

Nevertheless, government officials are already talking of a trade deficit for 1981 somewhat in excess of last year's. Similarly, with foreign earnings of many major corporations affected unfavorably (when translated into dollars) by the decline in foreign currency values, one of the traditional props of the U.S. international position—income from corporate investments abroad—also is likely to grow less rapidly. Such income amounted to $37 billion in 1980.

It is reasonable to predict, therefore, that as the U.S. current account moves toward a deficit again—perhaps early next year—expectations about the dollar will likewise begin to shift. By how much and for how long such an adverse shift will last may depend on differentials in interest rates at the time. Contrary to the popular myth, however, there is no foundation to the notion that a current-account deficit is a sign of a "weak" economy and automatically must lead to a weakening of a country's currency.

It is often forgotten that the United States was in deficit for about the first 100 years of its history. But that short-fall was financed or offset by foreign capital flowing into the country for the building of its industrial base and its infrastructure, such as roads and transportation facilities. Thus, even today a relatively stable dollar, reflecting noninflationary policies and a relatively high real rate of return, could go hand in hand with a current-account deficit, financed largely by foreign funds seeking investment here.

John Hein

J. Frank Gaston, Editor
A bimonthly report from

THE CONFERENCE BOARD, INC.
845 Third Avenue, New York, N.Y. 10022
(212) 759-0900 Telex 234465 and 237282

THE CONFERENCE BOARD OF CANADA
25 McArthur Road
Ottawa, Ontario, K1L-6R3, Canada
(613) 746-1261

THE CONFERENCE BOARD IN EUROPE
Avenue Louise, 207 - Bte 5
B-1050 Brussels, Belgium
(02) 640 62 40 Telex 63635

R4105 - 17.15A

The Conference Board

Worldbusiness Perspectives No. 63
October 1981

HIGH U.S. INTEREST RATES: Their Impact on Other Countries

For the third consecutive year, rates of growth in real economic activity are expected to remain below average in 1982 for the major industrial countries as a group. According to estimates made by the OECD (Organization for Economic Cooperation and Development) early in June, 1981, real growth for the United States and four major European countries will average between 1 and 1.5 percent annually. In Japan, real growth will average 4 percent, up slightly over 1981. Economic developments since these estimates were made would, if anything, lower these figures.

To date, in 1981, U.S. domestic economic policies have been regarded as largely responsible for the abnormally high levels of interest rates in other major countries and for the slowdown in real economic growth throughout the world. In contrast, U.S. domestic policies in earlier years were often seen as being an engine of inflation. According to the former view, high U.S. interest rates have forced the monetary authorities in other countries to raise their own interest rates above the levels that are appropriate for their domestic economic activity or, alternatively, face sizable outflows of capital that lower their exchange rates below desired levels.

High Interest Rates Abroad

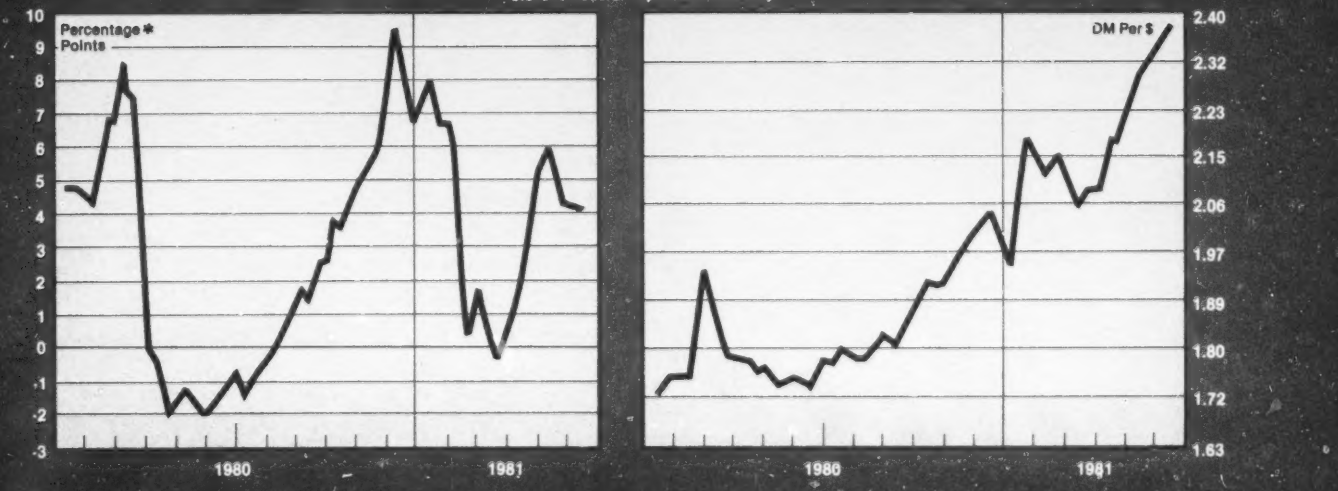
It is an oversimplification to regard high U.S. interest rates alone as the sole, or even the major, cause of higher interest rates in other countries. And the effects of high U.S. interest rates, while important, should not be viewed narrowly.

During most of the period of floating exchange rates (since 1973), the foreign-exchange value of the currencies of countries with relatively low interest rates

Chart 1:

Comparison of Interest Rate Differential and Exchange Rate

U.S. and Federal Republic of Germany



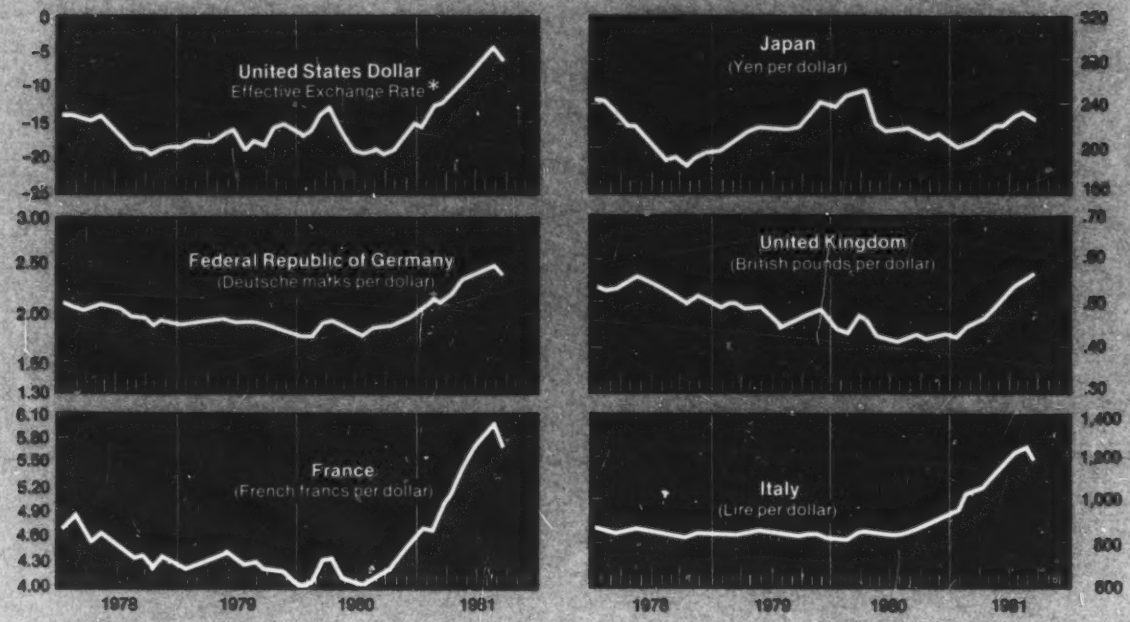
* US-CD rate minus Federal Republic of Germany interbank rate

Source: O E C D

© 1981 The Conference Board, Inc.

Chart 2:

Foreign Exchange Rates



*Effective exchange rate for the dollar shows its trade-weighted changes against the currencies of 15 trading partners, with a rise indicating its appreciation.

Source: Morgan Guaranty Trust

generally strengthened against the currencies of countries with high interest rates. Indeed, high interest rates were often regarded as one of the unfavorable consequences of deeply rooted inflationary problems that were not as serious in the so-called low-inflation countries, such as the Federal Republic of Germany or Switzerland, as they were in other major countries.

Developments in 1981 suggest that the influence of high U.S. interest rates on economic activities overseas should not be exaggerated. In the first quarter of 1981, short-term interest rates in the United States fell sharply. The rate on 90-day CD's (certificates of deposit), a representative rate for money-market instruments, fell from over 20 percent in late December (1980) to less than 14 percent by the end of March. By comparison, short-term interest rates in the Federal Republic of Germany rose during the same period so that the difference in money-market interest rates which had favored the dollar by roughly 7 to 8 percent was reduced sharply and temporarily reversed (see Chart 1). While the dollar weakened slightly for about a month, its value against the deutsche mark was substantially higher at the end of the first quarter than it had been at the beginning of this period.

There is yet another reason for not viewing U.S. interest rates as the sole—or most significant—cause of higher interest rates overseas. Figures through mid-1981 and beyond show that the rates of growth in money and credit in most of the major industrial countries were running above their targeted levels. In order to meet their own internal monetary targets, the monetary authorities in these countries would, therefore, have had to pursue policies that would have resulted in rising interest rates in their countries, quite independent of movements in U.S. interest rates.

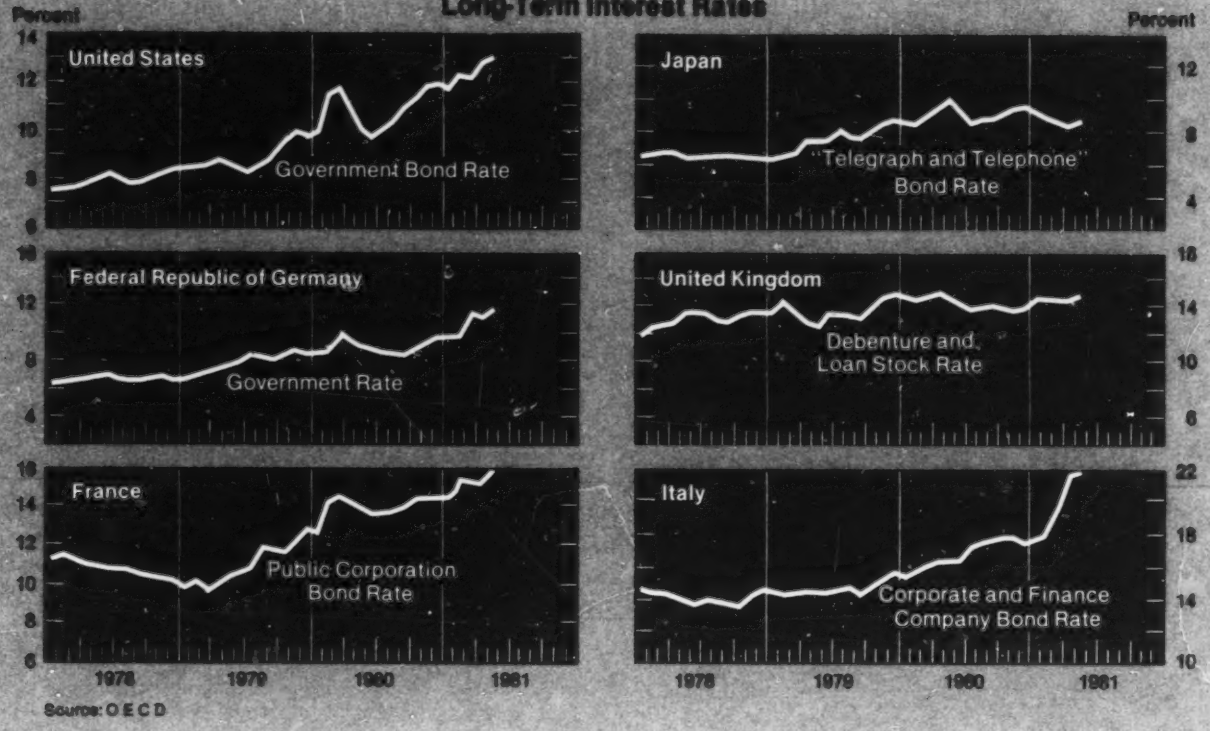
A broader explanation of the strength of the dollar suggests that more fundamental forces than high interest rates alone were responsible for these movements in foreign-exchange rates. Participants in these markets were starting to place greater weight on the likelihood that political, social and military changes were taking place that would strengthen the position of the dollar; that fundamental changes in U.S. economic policies had been initiated; and that the strength in the U.S. current account was likely to continue. Whether or not the dollar's strength has in fact been due to these fundamental changes, it could well be the case that the very sharp rise in the dollar itself "contains the seeds of its own reversal," as described in the preceding issue of this publication (John Hein, "The Resurgent Dollar: A Look at Fundamentals," *Worldbusiness Perspectives*, August, 1981).

Conflicting Signals of U.S. Policy

Despite the unusually high rates of interest in the United States this year, there is still considerable debate

Chart 3

Long-Term Interest Rates



Source: O E C D

among financial experts as to whether the monetary policies of the Federal Reserve have, in fact, been restrictive. Monetary experts who place greater emphasis on the narrower measures of money interpret policy to have been restrictive. M1B, which consists of currency plus checkable deposits at all depositary institutions, has grown at a rate of less than 2 percent, well below its targeted range of 3.5 to 6 percent; and there has been no growth at all in M1B from late April through September. In contrast, broader measures of money (such as M2, which includes M1B plus savings and small time deposits, shares in money-market mutual funds, overnight repurchase agreements issued by commercial banks, and overnight Eurodollar deposits held by U.S. residents at Caribbean branches of U.S. banks) are growing above the upper limits of their targeted ranges and, viewed alone, suggest that Federal Reserve policy has been expansive. The high levels to which interest rates themselves have risen encourage more efficient cash management and slower rates of growth in the low-yielding components of M1B. They also encourage more rapid expansion to take place in the higher yielding components of M2 and M3 (money-market mutual funds have, for instance, grown by roughly $85 billion, more than doubling since the beginning of 1981).

Other traditional measures that have been used to judge the tightness of monetary policy also provide conflicting signals of the degree of restrictiveness. Both the actual level of interest rates and the level of interest rates adjusted for inflation suggest that policy has been restrictive by past standards. Even after the decline in short-term interest rates in September, 1981, these rates remain well above historical levels, and many companies are continuing to postpone their plans to fund short-term debt.

To date, however, there have been no serious problems with respect to the availability of funds; and new commitments and lines of credit have been generously provided to those borrowers who are willing to pay for them. Financial experts who judge tightness by the availability of total credit are, therefore, inclined toward the view that the U.S. economy has yet to experience restrictive policy in 1981.

Lowering Inflation

The outlook for 1982 is that rates of inflation are generally expected to abate somewhat for the larger OECD countries. The major economic forecasts of the United States (summarized in The Conference Board's *Statistical Bulletin* for September, 1981) all show lower annual rates of inflation in 1982 than in 1981. Given the unanimity of these views, the question arises as to why interest rates still remain at relatively high levels today, and also why, barring a severe recession, only relatively modest declines in interest rates are generally expected

for 1982. The latter is particularly surprising since participants in financial markets place greater emphasis on the short-term outlook and seldom look beyond six to twelve months. The puzzle could, of course, be resolved by either a drop in interest rates or a rise in the expected rate of inflation.

The new high levels of interest rates are, to some extent, the result of a one-time adjustment to structural changes that have been taking place during the past few years. In the United States, the average cost of funds to banks and thrift institutions has been raised substantially by shifts in the composition of the liabilities of these institutions—shifts that are unlikely to be reversed. For instance, with the advent of nationwide NOW accounts (negotiable order of withdrawal) in 1981, consumers have moved huge amounts of money out of demand deposits, which yield no interest, into NOW accounts, which pay 5.25 percent; and they have moved even larger sums from low-yielding time and savings accounts into new and much higher yielding financial instruments such as six-month certificates or money-market funds.

This higher level of interest rates may also reflect the greater uncertainty, and perhaps greater skepticism, that the progress made in lowering inflation will be more than temporary. After all, there were earlier periods during which inflation abated following severe declines in the economy; but, in retrospect, the trend rates of inflation and interest rates continued to rise. On the basis of past experience, therefore, financial market participants may wish to err by being on the high side and allowing more time in which to see if the Federal Reserve and the Administration are able to persist in lowering the base rate of inflation over a period of years.

Changes in the way the Federal Reserve conducts monetary policy provides yet another explanation for the relatively high level of present interest rates. The monetary authorities have become more conscious of the role played by real interest rates and have allowed unusually high real rates to discourage borrowing and to reward saving in their efforts to reduce inflation. (These high rates may be regarded as a by-product of Federal Reserve efforts to meet money and credit targets.) Also, procedural changes since October, 1979, have allowed wider fluctuations in interest rates, and a part of existing rates may reflect an allowance for the uncertainties that are associated with these wider fluctuations.

Reducing Money GNP

Finally, the Federal Reserve has responded in the past (including 1980) to sharp declines in economic activity by aggressively easing policy. Of course, judgmental decisions are made in conducting policy, and an important message being given by Chairman Volcker is that the Federal Reserve does not intend to repeat past actions in which the monetary authorities, in combating recession, helped to build the base for further inflation. Since monetary policy works through its effects on interest rates, these statements have been interpreted to mean that interest rates will decline only modestly, even if real economic growth in the United States slows to 1 percent in 1982. There is clearly some discrepancy between the expectations that interest rates will remain high and the view that the Federal Reseve will primarily pursue its money targets, with interest rate adjustments taking place as a by-product of these actions to control money. The procedural changes in monetary policy initiated in October, 1979, carried to their extreme, allow interest rates to fall to zero percent, if that were to be the rate that would result from keeping money growth on target.

At this point, the Federal Reserve is aiming at further reductions in the rates of growth of money in 1982. The new midpoint of money narrowly defined (M1) for 1982 is 4 percent, or a rate that is three-quarters of a percent below that of the roughly comparable 1981 target; and actual growth rates of the broader aggregates (M2 and M3) are expected to be closer to their midpoints than to their upper ranges; to date, in 1981, they have been growing at the top of—or above—their upper ranges. A number of monetary experts have noted that these goals, if achieved, imply that the respective income velocities of money would grow at rates well above their historical averages if money GNP were to increase by 11 percent or more. Above-average growth in income velocity is usually associated with high or rising interest rates.

The overall strategy of the monetary authorities appears to be one of restraining inflation through gradual reduction of the rate of growth of money GNP. This approach allows room for increases in real economic growth if inflation abates. In the past, however, the main effects of lowering money GNP have normally been on real output. Without a significant change in the outlook for inflation, a continuous reduction in money and credit could result in a prolonged period of low economic growth.

Vincent G. Massaro

J. Frank Gaston, Editor
A bimonthly report from

The Conference Board, Inc.
845 Third Avenue, New York, N.Y. 10022
(212) 759-0900 Telex 234465 and 237282

The Conference Board of Canada
25 McArthur Road
Ottawa, Ontario, K1L-6R3, Canada
(613) 746-1261

The Conference Board, Inc.
Avenue Louise, 207 Bte 5
B-1050 Brussels, Belgium
(02) 640 62 40 Telex 63635